RESEARCH HIGHLIGHTS

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AN EVALUATION OF HOUSING TAXATION MEASURES

Introduction

The objective of this research project is to analyze and evaluate the existing housing taxation measures that the housing industry believe are inappropriate and pose a constraint to the effective functioning of the housing market.

The report evaluates income tax and GST measures on the basis of four taxation principles: effectiveness, efficiency, equity and affordability. Underlying these principles are the following attributes: simplicity, neutrality, flexibility, certainty and predictability, taxpayer awareness and acceptance, low compliance and administration costs, integration, international harmonization, non-arbitrariness, relief from transitional problems, and visibility. The report discusses and evaluates the housing taxation measures in the context of these principles and attributes.

A framework is developed for analyzing the housing tax measures. This framework is intended to explain the technical aspects of each measure, to describe the stated rationale and the consequences of each measure, and to analyze the extent to which applicable taxation principles are achieved.

The housing tax measures evaluated in the report are:

Income Tax Measures

a) Exclusion of specified investment businesses from the small business deduction.
b) Former business property rules.
c) Requirement to include rental properties costing in excess of $50,000 in a separate Capital Cost Allowance (CCA) class.
d) CCA limits imposed on rental properties.
e) Deductibility limits imposed on certain soft costs incurred during the construction, renovation or alteration of a rental property.
f) Rules related to the enforced capitalization of interest and property taxes incurred with respect to vacant land.

GST Measures

a) New residential home GST rebates and new residential rental property GST rebates.
b) Definition of substantial renovation of a rental property.

Housing Taxation Measures

Small Business Deduction: The small business deduction reduces the effective corporate rate on the first $200,000 of active business income generated by a Canadian-controlled private corporation from 28 per cent to 12 per cent. This tax preference is available only to activities which are "active" by nature.

The Department of Finance distinguishes between rental property income (passive income) and income from a business (active income). The deduction is not available for income from property or for a specified investment business. Indeed, income earned by a corporation which generates rental income does not qualify unless more than five full-time employees are employed throughout the year.

Denying the preference to specified investment businesses conforms to Finance's policy of not providing preferences to passive income and hence, to the objective of the small business deduction and government policy with respect to income from property. The small business deduction attains all of the principles of taxation for non-specified investment businesses.

Exchanges of property: The former business property rules allow an individual or corporate taxpayer to defer a capital gain or recapture on the disposition of property used to carry on a business provided that a replacement property is (a) acquired within one year from the end of

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the taxation year in which the disposition occurs, (b) used for the same or similar purpose as the former property, and (c) used in the same or similar business as the former property.

In effect, the capital gain or recapture on the former business property is deducted from the capital cost of the replacement property. Rather than reporting the capital gain or recapture in the year of disposition, future CCA claims are reduced over the life of the new property. The rationale of this measure is to allow businesses to relocate without incurring immediate tax consequences. This tax preference is not extended to former rental properties.

The effectiveness, efficiency and equity principles have been largely achieved. The affordability principle is only partially attained for owners of rental properties who wish to acquire a larger rental property. In fact, funds available for re-investment are reduced or the selling price of the unit must be increased in order to generate the same after-tax funds as a business property owner.

Separate Class Rule: Each rental property costing \$50,000 or more normally assigned to Classes 1 or 3 must be placed in a separate class [Regulation 1101(1ac)]. As the rental property is the only property in its class, disposition of the property potentially triggers a capital gain and immediate recapture of previously claimed CCA, which must be reported as income in the year of disposition.

The separate class designation was intended to preserve the integrity of the tax system by denying wealthy individuals the ability to shelter recapture by reinvesting in new properties.

The effectiveness, equity and affordability principles have been largely achieved. However, the second-order efficiency principle has been partially attained due to the fact that tax consequences of a disposition of a rental property, forced into a separate class, are generally neither certain nor predictable and that the \$50,000 threshold is not realistic in today's business environment because many taxpayers who cannot be considered wealthy are now caught by this provision.

CCA Loss Restrictions: Regulation 1100(11)-(14.2) restricts the CCA that can be claimed against rental income to the amount of the cash-based income when the rental property is used primarily (i.e., more than 50 per cent) to produce gross revenue that is rent. The loss restriction rule applies to all properties owned by a taxpayer on an aggregate basis, not on a property-by-property basis.

In effect, a rental property owner cannot create or increase a loss by claiming CCA. The rule does not apply to principal business corporations. Therefore, the rule primarily affects individual rental investors, as many corporations engaged in rental activities qualify as principal business corporations.

The CCA restriction was enacted along with the separate class rule to deny high-income taxpayers the ability to shelter income by deducting CCA created rental losses. The effectiveness, efficiency, equity and affordability principles are largely achieved with respect to the loss restriction rule.

Soft Cost Capitalization: Subsection 18(3.1) denies the immediate deduction of certain so-called soft costs attributable to the construction, renovation or alteration of a building or the ownership of land subjacent and contiguous to the constructed, renovated or altered building. These costs must be capitalized—that is, added to the capital cost of the building.

The effect of this provision is to spread the deduction for the soft costs over the life of the building as part of the annual CCA deduction. This restriction applies equally to all taxpayers. There is no exception for principal business corporations.

The soft cost capitalization was introduced to improve the fairness of the tax system and for revenue generation purposes. The effectiveness and equity principles have been attained. The efficiency principle has not been attained because of the complexity introduced by this rule when it is applied to specific situations and consequently the onerous compliance costs associated with this measure. Finally, the affordability principle is only partially achieved due to the decrease of funds available for re-investment for rental property owners.

Interest and Property Tax Capitalization: Pursuant to the general rule of subsection 18(2), interest related to the acquisition of, and property taxes on, vacant or idle land, are not deductible in the year incurred. This provision applies primarily to taxpayers who hold vacant land for inventory purposes, land held but not yet used for producing income (for example, land held for expansion), taxpayers whose business is the development and resale of vacant land, or land held for speculative purposes.

This tax measure was introduced, essentially, to penalize taxpayers who hold land off the market and to make developers convert their land inventories to development purposes.

The effectiveness and equity principles have been largely achieved. However, the second-order efficiency principle has only been partially attained due to interpretation problems associated with the wording of the measure and the significant additional costs of complying with the measure. With respect to the affordability principle, the reduction in the developer's cash flow and overall

liquidity due to the forced capitalization of interest and property taxes result in this principle being only partially achieved.

GST Rebate: Purchasers of newly constructed or substantially renovated residential homes are entitled to a rebate equal to 36 per cent of the GST paid on the home. The full rebate applies to newly constructed or substantially renovated homes which cost the purchaser $350,000 or less before the GST. The rebate is reduced if the purchaser's cost is between $350,000 and $450,000. A similar rebate program is available for newly constructed or substantially renovated residential rental properties.

The new housing rebate was introduced to preserve housing affordability in Canada and to strengthen the fair treatment between homeownership and rental housing, and between new construction and substantial renovation.

The effectiveness, equity and affordability principles have been largely achieved. The efficiency principle has been partially attained due to the complexity of the measure and the consequent increased compliance and administration costs.

The Principles of Taxation

Each principle and its underlying attributes are categorized as first, second, or third-order concerns, based on their monetary or compliance cost to the housing sector. First-order concerns apply to most tax measures or are of profound importance to the subset of the tax system being evaluated (in this report, the housing sector). Tax measures deemed deficient at this level require immediate legislative action. Second-order concerns are of relatively less importance to the subset. Tax measures deemed deficient at this level require legislative action, but not necessarily as quickly as deficient first-order measures. Third-order concerns are important to selected segments of the tax system, but are of relatively little importance to the specific subset being evaluated. No legislative action is required of measures deemed deficient at this level, as the principle either does not apply to the subset being analyzed, or is of so little importance that immediate action is not warranted.

Effectiveness

The essential effectiveness criterion can be expressed as follows: Did the measure achieve its stated objective(s)? A tax measure is considered to be effective if it has attained its legislative objective. Effectiveness, therefore, relates to the attainment of short and long-term economic management, international objectives, income redistribution, social policy and cultural or nationalistic objectives.

Efficiency

Efficiency relates to the simplicity of a tax measure, its certainty and predictability, understandability, flexibility, ease of compliance and administration, non-arbitrariness and visibility.

Equity

Equity refers to the inherent sense of fairness and equality of the measure. This principle relates to the consistency, neutrality and integration of a tax measure.

Affordability

This principle refers mainly to a taxpayer's increased tax burden resulting from discriminatory legislation. A key aspect of this tax measure is the ability of the taxpayer to pay.

The Evaluation of the Taxation Measures

A summary of the tax measures evaluation based on the principles of taxation is presented below. The table indicates whether the principles of taxation are deemed to have been not attained, partially attained or attained for each tax measure.

Table 1: Summary of the Tax Measures Evaluation

Measure	Effectiveness	Efficiency	Equity	Affordability
Exclusion from Small Business Deduction	Attained	Attained	Attained	Attained
Exchanges of Property	Attained	Attained	Attained	Partially Attained
Separate Class Rule	Attained	Partially Attained	Attained	Attained
CCA Loss Restrictions	Attained	Attained	Attained	Attained
Soft Cost Capitalization	Attained	Not Attained	Attained	Partially Attained
Interest and Property Tax Capitalization	Attained	Partially Attained	Attained	Partially Attained
GST Rebate	Attained	Partially Attained	Attained	Attained

Effectiveness

All measures were deemed effective in that they have attained the legislated objective of the measure - that is, pursuant to the wording of the provision, the only outcome is that intended by the legislation.

Efficiency

The second-order efficiency principle has not been attained with respect to the soft cost capitalization rule, and partially attained for the separate class rule, the interest and property tax capitalization rule, and the GST rebate. However, the deficiencies noted with respect to soft cost and interest and property tax capitalization, and the GST rebate, relate to interpretation problems (and the consequent increased compliance costs) associated with the wording of the measures. The separate class rule was considered deficient in that the $50,000 threshold is insufficiently flexible as it has not been increased since 1972. This threshold was originally intended to deny wealthy taxpayers the ability to indefinitely defer recapture. Many taxpayers who cannot be considered wealthy are now caught by this provision.

Equity

All tax measures discussed in this report are considered to have attained the first-order equity principle. The central debatable issue in this report is whether or not rental operations are similar to businesses. The rental sector believes this to be the case, and has lobbied for tax preferences similar to those available to businesses.

Affordability

The exchange of property rules, and the capitalization of soft costs and interest and property taxes on vacant land, were deemed partially deficient with respect to the first-order affordability principle. However, the reason for this conclusion is not that they render the taxpayer less able to pay the resulting taxes, but (a) denial of a recapture or capital gain deferral on disposition of a rental property reduces the funds available for re-investment, and (b) all three measures generally impair the cash flow of the rental property owner.

Conclusion

Based on the evaluation of principles, all existing tax measures are deemed to have largely attained the effectiveness and equity principles. Certain deficiencies are noted with respect to the efficiency principle. Several measures are considered to have partially attained the affordability principle, primarily because they reduce the quantum of re-investment funds available to the rental property owner.

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Housing Research at CMHC

Under Part IX of the *National Housing Act*, the Government of Canada provides funds to CMHC to conduct research into the social, economic and technical aspects of housing and related fields, and to undertake the publishing and distribution of the results of this research.

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